

Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [REDACTED]: TL-N-6908-99
[REDACTED]

VIA FACSIMILE ONLY

date: FEB 22 2000

to: Chief, Examination Division, [REDACTED]
Attention: Revenue Agent [REDACTED]

from: District Counsel, [REDACTED]

subject: [REDACTED]
Debt and interest dischargeability

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This is to supplement the December 27, 1999 memorandum based on the additional facts secured by Revenue Agent [REDACTED]

ISSUE:

1. Whether the taxpayer must recognize income on the discharge of indebtedness for the debt principal incurred when it purchased its own stock from its former shareholders?

(a) Whether the purchase price reduction exception under I.R.C. § 108(e)(5) applies to the principal debt?

CONCLUSION:

1. The taxpayer **must** recognize income on the discharge of indebtedness for the debt principal incurred when it purchased its own stock from its former shareholders.

(a) The purchase price reduction exception under I.R.C. § 108(e)(5) **does not apply** to the principal debt since the taxpayer no longer has the property.

FACTS AND DISCUSSION:¹

[REDACTED] is under examination by the Internal Revenue Service for the fiscal year ending [REDACTED]. On [REDACTED], the beginning of the fiscal year, [REDACTED] had debt on its books of \$ [REDACTED] and accrued interest of \$ [REDACTED], both of which were related to the purchase of [REDACTED] stock from former shareholders (creditors). The original principal balance was \$ [REDACTED] on [REDACTED], which was represented by a note bearing [REDACTED] % interest. [REDACTED] and the creditors agreed on [REDACTED] to a reduction of principal and interest for an immediate payment of \$ [REDACTED].

Based on the analysis contained in our December 27, 1999 memorandum, Revenue Agent [REDACTED] issued an IDR to the taxpayer seeking additional information on the debt and property including any disposition of either. The information provided by the taxpayer indicated that it no longer had possession of the corporate stock that was the purchased property. The disposition of the asset precludes application of a purchase price reduction under I.R.C. § 108(e)(5).

The facts of the property purchase and debt incurred as a result thereof are as follows. [REDACTED] formed an employee stock ownership plan (ESOP) as a mechanism to transfer ownership of the company from the existing shareholders to the employees. This was in large part based on concessions made by the employees which were made for competitive purposes. Since the ESOP had no assets, [REDACTED] purchased the stock from the former shareholders for cash and a note. The cash was secured from a bank by [REDACTED]. The ESOP in turn gave [REDACTED] notes for the debt and cash portions of the purchase price. [REDACTED] forgave the debt due from the ESOP between

¹ The facts which form the basis for this opinion were derived from the [REDACTED] memorandum to the file which was provided by [REDACTED] to the Internal Revenue Service as supplemented by the taxpayer's response to IDR #3. The veracity of the facts may bear on the determinations expressed herein.

[REDACTED] and [REDACTED]. The stock was transferred proportionate with the debt reduction to the employees' individual ESOP accounts during the period comparable with the ESOP debt discharge. As of [REDACTED] [REDACTED] no longer owned any of the corporate stock.

The purchase price of the [REDACTED] stock was subsequently reduced since [REDACTED] believed that the corporate stock was overvalued because of unknown and undisclosed liabilities. Ironically these liabilities were taxes owed to the Internal Revenue Service pursuant to an audit. The declining financial stability of [REDACTED] was also a factor.

Forgiveness of indebtedness - debt principal:

The taxpayer alleges that the cancellation of the indebtedness for the principal balance is excepted from taxable income as a reduction of purchase price under I.R.C. § 108(e)(5). The I.R.C. § 108(e)(5) purchase price reduction was added by the Bankruptcy Tax Act of 1980. Sutphin v. United States, 61 AFTR2d ¶ 88-990 (Ct. Fed. Claims 1988). It codified the common law and provided for a basis reduction instead of immediate gain. Preslar v. Commissioner, 167 F.3d 1323 (10th Cir. 1999). It was enacted to create uniformity and eliminate disagreements between taxpayers and the Internal Revenue Service as to whether cancellation of indebtedness were true price reductions. Id; Brantley v. Commissioner, T.C. Memo. 1995-564.

In order to facilitate the objective of eliminating disagreements, the application of I.R.C. § 108(e)(5) is a mechanical test. To apply, there must be a direct agreement between the buyer and seller. Preslar v. Commissioner, supra; DiLaura v. Commissioner, T.C. Memo. 1987-291; and Rev. Rul. 92-99, 1992-46 I.R.B. 5. The legislative history also indicated that: (1) the reduction could not be due to the expiration of the statute of limitations; (2) the debt could not have been transferred to a 3rd party; and (3) the purchased property could not have been transferred to a 3rd party. Since the purchased property was transferred to the [REDACTED] employees through the ESOP, the corporation no longer owned the property for which the purchase price reduction is sought. Accordingly, the purchase price reduction exception to the cancellation of indebtedness income does not apply.

In summary, we do not believe that the debt reduction qualifies under I.R.C. § 108(e)(5) as a purchase price reduction since one of the three requirements is not satisfied.² Id. Although it appears that the taxpayer would have been entitled to a purchase price reduction under the common law and the case law prior to codification because of the reasons for which it was reduced, the reason that the debt was canceled is no longer relevant in light of I.R.C. § 108(e)(5) (except for the uncollectibility of the debt for statute of limitations reasons).

Please contact the undersigned at [REDACTED] if you have any questions. We are again seeking post-review by the National Office due to the uniqueness of the issue. We should hear back from them shortly. In the interim, you should consider the extent that factual development is necessary and/or draft a proposed position in order to seek the taxpayer's position.

[REDACTED]
District Counsel

By: [REDACTED]

Senior Attorney

² The I.R.C. § 108(e)(5) provisions are not elective. Zarin v. Commissioner, 92 T.C. 1084 (1989), rev'd, 916 F.2d 110 (3rd Cir. 1990).